BEFORE THE
SOUTH CAROLINA PUBLIC SERVICE COMMISSION
DOCKET NO. 2004-6-G

ANNUAL REVIEW OF THE PURCHASED)
GAS ADJUSTMENTS (PGA) AND GAS)
PURCHASING POLICIES OF)
SOUTH CAROLINA PIPELINE)
CORPORATION)

SURREBUTTAL TESTIMONY OF GLENN A. WATKINS

ON BEHALF OF THE
SOUTH CAROLINA CONSUMER ADVOCATE

May 24, 2004

Technical Associates, Inc.

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OF
GLENN A. WATKINS

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Glenn A. Watkins. My business address is James Center III, Suite 601, 1051 East Cary Street, Richmond, Virginia 23219.

Q. HAVE YOU PREFILED DIRECT TESTIMONY IN THIS PROCEEDING ON BEHALF OF THE CONSUMER ADVOCATE?

A. Yes.

Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

A. The purpose of this testimony is to respond to the rebuttal testimonies of Mr. Thomas R. Conard and Dr. Julius A. Wright on behalf of South Carolina Pipeline Corporation ("SCPC").

Q. PLEASE PROVIDE AN OVERVIEW OF MR. CONARD'S REBUTTAL TESTIMONY.

A. On page 21 of my direct testimony, I stated that firm ratepayers would have saved $11,005,000 during 2003, had ISPR and Firm resale customers paid the same commodity cost of gas rate. Mr. Conard's rebuttal testimony is devoted to explaining the revenue requirement impact on SCPC and its customers had this $11 million savings been realized by firm ratepayers and all of the $11 million were lost by SCPC.

While I have not verified the amounts presented in Mr. Conard's testimony, the fallacy of his analysis is the assumption that all of the $11 million in revenue would have been lost. As I will explain in my comments on Dr. Wright's rebuttal testimony, this revenue erosion is grossly overstated and could be made up with additional transportation revenues. However, and as I stated in my direct testimony, should the termination of the current accounting manipulations regarding SCPC's cost of gas result in the need for a realignment of SCPC's rate structures, this is appropriate and proper regulatory policy. I will be the first to agree that SCPC needs to earn a reasonable profit to remain financially viable and that a significant loss of revenue from any regulated source of income may necessitate the need for a rate case. However, the current practice of pretending that interruptible commodity gas costs are lower than they actually are and intentionally assigning the gas cost subsidy to captive classes of customers is not sound regulatory policy and is unduly discriminatory to these captive customers.

Q. PLEASE COMMENT ON THE REBUTTAL TESTIMONY OF DR. WRIGHT.

A. Dr. Wright levies several criticisms regarding my knowledge and real world application of economic price theory, analyses, and quantification of SCPC's cost of gas. In addition, Dr. Wright attempts to mislead this Commission by implying that several other states have programs similar to SCPC's ISPR program and that the continuation of the ISPR is critical to economic development of South Carolina.

Q. PLEASE DISCUSS DR. WRIGHT'S CHALLENGE OF YOUR KNOWLEDGE AND APPLICATION OF REAL WORLD ECONOMIC PRICE THEORY.

A. On page 13 through 18, Dr. Wright provides a discussion of why marginal costs cannot (should not) be considered in the regulatory arena; that I somehow do not understand "more advanced economic theory"; and that the marginal cost to interruptible customers may be lower than the average variable commodity cost of gas.

First and foremost, I am not proposing that South Carolina should institute marginal cost pricing as its regulatory standard. This is not the appropriate forum to discuss the advantages and disadvantages of marginal cost pricing, as no such discussion is needed. My discussion of the marginal or incremental cost of gas was to provide the Commission with a brief overview of the economic and legal standards by which undue price discrimination is defined. As I stated on page 18 of my direct testimony, I believe that gas costs should be assigned to all customers based on **average costs,** not marginal costs.

Regarding my knowledge of "more advanced economic theory," I will simply state that Dr. Wright grossly distorts the application of marginal cost pricing in practice. Trained experts use their knowledge of theory that has been developed for optimal social solutions (perfect world scenarios). This theory is then applied to real world (less than perfect) situations. With this application, the best practical (often second best) solutions can be found.

With respect to my knowledge and application of more advanced economic theory, I have conducted utility marginal costs studies in numerous states on numerous occasions over the last 24 years for commissions that required marginal cost pricing consideration, including Maine, Michigan, Illinois, Virginia, Washington D.C., and FERC. My firm and I have served as technical advisors to the Washington D.C. Public Service Commission Commissioners since the mid-1980s on marginal cost pricing issues, and I have lectured on utility marginal cost pricing in practice.

Q. ON PAGE 9 OF HIS REBUTTAL TESTIMONY, DR. WRIGHT STATES: "THIS (ISPR) INCREASE IN GAS SALES COULD ALSO ALLOW THE COMPANY TO REDUCE ITS OVERALL COST OF GAS SIMPLY DUE TO ITS ABILITY TO PURCHASE GAS IN LARGER VOLUMES." DO YOU HAVE ANY COMMENTS REGARDING THIS STATEMENT?

A. Yes. Could, possible, or maybe are simply conjecture. Whether more purchasing power would lead to lower average gas costs is not the point at issue. It is critical to remember that the SCPC system is designed, built, and dedicated to firm customer's needs. Dr. Wright (and the Commission Staff historically) seems to forget the point that firm customers must be served first. With this said, and accepting the conjecture that gas costs might be lower due to increased purchasing power, it then follows SCPC's cost of gas would be higher without the firm sales already in place. However, all of this is putting the cart before the horse. Accepting the hypothesis that increasing purchasing power tends to reduce the overall average cost of gas, this is a benefit to SCPC's total gas costs and this benefit should be shared by all ratepayers. However, under the current situation, ISPR customers pay less than the actual cost, and firm customers are penalized by more than what is costs to purchase gas.

Q. ON PAGES 16 AND 17 OF HIS REBUTTAL TESTIMONY. DR. WRIGHT STATES THAT IT MAY BE BENEFICIAL TO ALLOW AN ISPR CUSTOMER TO PAY LESS THAN THE AVERAGE COST OF GAS IN SOME MONTHS BECAUSE THAT CUSTOMER MAY PAY MORE THAN AVERAGE COST IN OTHER MONTHS. DO YOU HAVE ANY COMMENTS ON THIS STATEMENT?

A. Yes. Dr. Wright's discussion is really directed at a criticism of marginal cost pricing, however I will discuss the overall logic in Dr. Wright's statements on this topic.

Dr. Wright implies that as long as a customer pays more than the average variable cost of gas over time then stakeholders (shareholders and ratepayers) are better off. I do not want to split hairs over the timing precision in which gas costs should be determined. Dr. Wright's discussion is premised on the fear that this hypothetical large customer will permanently shift to a fuel other than natural gas and thus will be lost forever. This is simply not a real world consideration as long as gas is properly priced in the market. As Dr. Wright admits, there is a clear preference for using natural gas over alternative fuels, and to the extent natural gas is reasonably priced, these industrial customers will continue to use natural gas whenever possible.

Q. DR. WRIGHT CLAIMS THAT YOUR CALCULATIONS OF THE COST OF GAS TO SERVE ISPR CUSTOMERS ARE FLAWED. DO YOU HAVE A RESPONSE TO THIS CLAIM?

A. Yes. I have several. First, Dr. Wright devotes the majority of his rebuttal testimony discussing the problems associated with marginal costs and criticisms of my calculation of the incremental cost of gas for ISPR customers. As I have clearly shown and described in my direct testimony, I have calculated three separate cost standards: two based on average variable costs and one on incremental costs. When I provided the $11 million savings that firm customers would have realized had all customers paid the same level of gas costs in 2003, this amount was based on average costs, not marginal or incremental costs. Moreover, when I provided dozens of examples in which ISPR customers are paying less than cost for gas in Schedule 6 of my direct testimony, these are based on average variable costs. Finally, as I stated on page 18 of my direct testimony, I concur with the general consensus that gas costs should be assigned based on average (not marginal or incremental) costs of gas.

There is, without a doubt, and unending chicken and egg argument regarding the determination of marginal or avoided costs of gas. In the real world, it may be impossible to determine the last block of gas purchased on a monthly basis. For all of the practical reasons, I believe proper regulatory policy is for all customers to be charged the average cost of gas.

With respect to the accusation that for incremental cost purposes (which does not apply to my two average cost standards) I cherry-picked to obtain the highest cost of gas in each month, I do not disagree with Dr. Wright's claim that I assigned the highest cost of gas first to interruptible customers. As I fully explained in my direct testimony, this is because SCPC purchases gas first, (at the cheapest rate) to fulfill the needs of firm customers, and after all of the firm requirements are met, only then does SCPC purchase gas on behalf of its interruptible customers. There is no evidence that SCPC has contractual obligations to purchase more gas than needed to fulfill the needs of firm customers, and hence this sound regulatory practice is reasonable. However, I reiterate my acknowledgment of the controversies surrounding the determination of the cost of the last unit purchased in a given month or time period, and advocate the assignment of gas costs based on average costs.

Q. DR. WRIGHT IMPLIES THAT SEVERAL NEIGHBORING STATES HAVE FLEXIBLE PRICING MECHANISMS SIMILAR TO THE ISPR. IS THIS CORRECT?

A. No. My research and conversations with Commission Staffs has failed to find any jurisdiction that arbitrarily assigns the cheapest cost of gas to interruptible customers. In fact, with the exception of Alabama, virtually all states assign the average commodity cost of purchased gas to all classes. While many states do have limited flexible pricing mechanisms, this flexible pricing requires reductions from tariff amounts to come from non-gas costs. For example, North Carolina has an economic development program. This program is available only to new load, and new customers that make a clear showing that it will be uneconomical to locate in North Carolina absent discounted gas rates. Then, any discounts are applied only to non-gas cost margins.

Similarly, Florida has certain LDCs that have approved flexible pricing mechanisms. However, all ratepayers are assigned, and pay the same commodity cost of gas. Any discounts to the total retail price are then subtracted from margins.

Alabama Gas Corporation has a Competitive Fuel Clause in which firm rate payers are assigned the differential between the actual cost of gas and the cost of alternative fuel prices as part of the Purchased Gas Adjustment ("PGA"). However, Alabama Gas also serves as a marketer of gas for transportation customers, with the proceeds from this marketing function credited to the PGA.

Q. DR. WRIGHT AND MR. CONARD DISCUSS THE FINANCIAL IMPACT ON SCPC AND ITS RATEPAYERS IF SCPC WERE TO LOSE $11 MILLION IN GAS COSTS. PLEASE COMMENT ON THIS TOPIC.

A. Should this Commission eliminate the merchant function gas subsidy provided to interruptible customers, those customers and revenue will not all be lost. For example, if costs are increased to interruptible customers, the customers will likely use SCPC transportation service and purchase their own gas. SCPC's interruptible transportation rate is $0.2842 per Dth. Given the total ISPR volumes purchased in 2003 (41,963,276) this would equate to $11.9 million which would more than offset the $11.9 million which would more than offset the $11.0 million subsidy created by the current ISPR program.

Q. DOES THE COMPLETE YOUR SURREBUTTAL TESTIMONY?

A. Yes.